Legislation to simplify the prudential supervision of non-bank financial institutions, such as building societies and credit unions, has had unexpected results. Peta Taylor and Jon Stanford report on the new regime which offered NBFI s the chance to expand but is seeing many of them retreat into the safety of small-time conservatism.

In July 1992, a new national system of prudential supervision was introduced for deposit-taking non-bank financial institutions (NBFI s), entailing the enactment of common state legislation and the establishment of a new national supervisory authority. While the new system remedied deficiencies of the old state-based system and provided new market opportunities for NBFI s, it has also led to adjustments which were not fully foreseen and which have brought substantial changes to the NBFI industry.

Intense competition from banks and other financial institutions will ensure that there is pressure for further change.

One group which has undergone considerable change is the building society sector. The effects of the legislative reforms, such as the capital-adequacy requirement of 8 per cent, resulted in many building societies facing capital shortfalls. To meet the requirements by the end of the two-year transitional period, many institutions have adopted new strategies which have changed the face of the building society industry forever. One Sydney-based building society, St George, converted to bank status in July 1992 and did not come under the new scheme, and the Co-operative Building Society of South Australia became the Adelaide Bank at the beginning of 1994. Other building societies have converted from the traditional mutual status to companies and, in the process, issued tradeable shares.

Credit unions are constrained by the legislation to remain as mutual societies and are unable to issue permanent tradeable share capital. Given the necessity to maintain minimum levels of capital, these restrictions oblige credit unions to boost their earnings so to increase retained profits, or to change their lending patterns.

A survey of the 31 building societies

Peta Taylor is a financial analyst with a large NBFI. Jon Stanford ASIA is an economist specialising in the analysis of financial institutions and markets. He was a member of the Brady Committee and was the Queensland government's advocate before the Prices Surveillance Authority's hearing on credit cards.
currently conducting business in Australia has provided insight into the views of management and the future direction of the industry. The prospects for the credit union sector are considered and possible changes are canvassed.

The new system

The new system of supervision has a two-tier structure: at the apex is the Australian Financial Institutions Commission (AFIC) which determines national prudential standards, and each state has a State Supervisory Authority which is responsible for the on-ground supervision.

The prudential standards include a capital adequacy requirement which is very similar to the BIS standard adopted for banks by the Reserve Bank of Australia: liquidity requirements similar to the prime assets ratio and supported by industry-provided liquidity schemes. The system differs from the Reserve Bank supervision of banks in providing for on-site inspections of NBFIs. In general, the prudential regulations are more stringent than those for banks, particularly having regard to the risks inherent in a mutual society.

Many institutions initially would have not been able to meet the capital adequacy requirements and a two-year interim period was established to allow for transitional arrangements.

Unlike the Reserve Bank's supervision of banks, which does not impose a charge on banks, the costs of the NIFI supervision scheme are fully met by an annual levy on NBFIs. This levy has at times been contentious, and continues to be a matter of concern for the industry.

The AFIC legislation comes after a period of review spanning a decade. The Martin Group inquiry into the financial system recommended against direct control over the NBFIs by the Commonwealth. Instead, it said, controls on NBFIs should be less rigid than those on banks and information-sharing between parties should be increased. It further proposed a uniform, state-based system of supervision.

In 1990, a committee of inquiry into NBFIs (the Brady Committee) was established in Queensland. The Brady Report recommended supervision by an organisation at arm's length from government, based on the Reserve Bank system, with co-operation between states. An agreement by state premiers for national supervision of NBFIs was put into effect by the uniform legislation passed by all states in 1992.

Non-bank financial institutions

Deposit-taking non-bank financial institutions are now constituted under the Financial Institutions Act, which requires minimum paid up capital. The Act distinguishes between building societies and credit unions; financial institutions must operate as one or the other, but not both. The Act further provides for "primary objects" which define building societies and credit unions: building societies' primary object is that at least 50 per cent of their loans must be for the purchase of residential property, while credit union rules limit membership to persons having a common body of association and stipulate that not less than 60 per cent of loans are to members.

The biggest building society in Australia is Suncorp Building Society Ltd, which is wholly owned by banks. The ultimate responsibility for the protection of depositors' funds rests with the taxpayers, rather than the supervising authority. The future of Suncorp is uncertain: the society may be removed from government ownership and this may cause it to change its building society status.

Building societies in Australia are now concentrated in Queensland where 40 per cent of the total assets reside. More than 90 per cent of the assets of the industry are concentrated in three States; it is highly regional, rather than national.

Credit unions are heavily concentrated in New South Wales, which has 44 per cent of industry assets, but they are represented on a significant scale in all states.

New prudential standards

The new prudential regulations have created two problems for NBFIs. The first is the need to raise more capital to meet capital adequacy requirements. The traditional means of raising capital

<table>
<thead>
<tr>
<th>Table 1: Total assets of NBFIs ($m), end-June</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building societies</td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>1990</td>
</tr>
<tr>
<td>1991</td>
</tr>
<tr>
<td>1992</td>
</tr>
<tr>
<td>1993</td>
</tr>
<tr>
<td>1993a</td>
</tr>
<tr>
<td>a Excludes assets of Cooperative Building Society of South Australia, which became Adelaide Bank in 1994.</td>
</tr>
</tbody>
</table>

Source: AFIC Annual Report

<table>
<thead>
<tr>
<th>Table 2: State distribution of building societies excluding co-ops</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number</strong></td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td>NSW</td>
</tr>
<tr>
<td>Vic</td>
</tr>
<tr>
<td>Qld</td>
</tr>
<tr>
<td>SA</td>
</tr>
<tr>
<td>WA</td>
</tr>
<tr>
<td>Tas</td>
</tr>
<tr>
<td>NT</td>
</tr>
<tr>
<td>ACT</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>a Less than 0.5 per cent</td>
</tr>
</tbody>
</table>

the Queensland government. At 30 June 1993, the total assets of Suncorp Building Society Ltd were just over $2.2 billion — more than 20 per cent of total industry assets. Suncorp Building Society Ltd has an anomalous status as the only government-owned building society in Australia; ownership of any other building society is restricted by the Financial Institutions Act to 10 per cent. Moreover, as experience with state-owned — from retained profits — is not suitable for coping with such a sudden demand. The second problem is that profit margins are under pressure as the new regulations impose increased liquidity requirements.

Building societies, in addition to the capital adequacy requirements, are required to maintain 10 per cent of liabilities as prime liquid assets and a further 10 per cent in operational liquidity. The societies have found that complying with
the new prudential regulations has put increased pressures on their current structure. Many societies had difficulty in meeting the capital requirement of 8 per cent. At 30 June 1993, three of the 31 building societies had not been able to comply with minimum capital requirements.

The capital and liquidity requirements have imposed additional strains in an already competitive market in which margins have been slowly eroded. The traditional backbone of the building society market—lending for owner-occupied housing—is disintegrating as banks and other institutions increase their focus in on this lucrative market following disastrous experiences in commercial lending.

For some institutions, the new legislation contains a further threat: it enables building societies, for the first time, to expand beyond their traditional regional and state boundaries and operate interstate. Not all institutions will be in a position to take advantage of this; some will undoubtedly feel the effects of new competitors in their markets. Suncorp Building Society is one institution planning interstate expansion.

The response of other building societies has been to:
- change to company structure and float on the Australian Stock Exchange;
- change their status and issue tradeable shares on an exempt market;
- raise Tier 2 capital by issuing subordinated debt;
- change their lending policy; or
- convert to banks.

Three building societies in Queensland, the Rock, Northern, and Ipswich and West Moreton, have converted to company status and listed successfully on the ASX. Two other Queensland building societies, Wide Bay and Mackay, have converted to company status and issued permanent shares which are traded on an exempt market.

Heritage Building Society, also in Queensland, has increased its Tier 2 capital by issuing subordinated debt.

St George, which converted to bank status on 1 July 1992, says that its conversion from a building society has been successful. Its 1993 annual report stated: “The bank continues to show the benefits of switching from being a building society to a bank with higher earnings on its liquid assets, more diversity in its wholesale funding and greater access to international markets.”

<table>
<thead>
<tr>
<th>Table 3: State distribution of credit unions excluding co-ops</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>NSW</td>
</tr>
<tr>
<td>Vic</td>
</tr>
<tr>
<td>Qld</td>
</tr>
<tr>
<td>SA</td>
</tr>
<tr>
<td>WA</td>
</tr>
<tr>
<td>Tas</td>
</tr>
<tr>
<td>NT</td>
</tr>
<tr>
<td>ACT</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

a Less than 0.5 per cent

Building societies have changed their lending policies to move away from loans for owner-occupied housing (only 53 per cent of assets in 1993) toward loans for residential investment and commercial loans (23 per cent of assets in 1993). The shift will increase gross margins but also increase risk exposure.

Credit unions

Credit unions, under the new regulatory system, are prohibited from issuing shares and are required to hold 75 per cent of their capital as Tier 1. Credit unions are also required to maintain 7 per cent of total liabilities as prime liquid assets and a further eight per cent of operational liquidity. At 30 June 1993, 14 credit unions had not met the capital requirements.

Credit unions have responded to the new regulations by:
- increasing the level of reserves from retained profits;
- increasing their lending for owner-occupied housing; and
- changing their lending policies.

They have improved their capital adequacy position without having to raise more capital by increasing their lending for owner-occupied housing. The stylised balance sheet in Figure 1 shows how this can be done.

The proportion of owner-occupied housing loans in credit unions’ books has doubled since 1988 and now accounts for 25 per cent of total assets. In consequence, personal loans, the backbone of the industry, have fallen to 50 per cent. The fall in credit unions’ personal loans reflects their attempts to reduce bad debts in the area (and thus maintain retained profits) and increased competition from finance companies in consumer loans for motor vehicles. Finance companies, using sophisticated credit scoring models, can approve loans quickly and with a minimum of documentation. Credit union procedures remain cumbersome and approval is delayed by need to refer to a credit committee.

The pressure on credit union margins will continue as the banks attempt further penetration of the home-loan market, building societies attempt to maintain their market share and other financiers improve their competitive loan products.

The scope for credit unions to improve their capital adequacy by changes in the portfolio will be limited, and they will confront the problem of having to raise real capital or remain constrained by the low growth in retained profits.

The future of societies

The financial institutions legislation prescribes on the structure of building societies and the prohibition on credit unions issuing permanent tradeable share capital are inconsistent with the philosophy of deregulation of the financial sector.

A desirable policy change in the legislation would be to provide for one class of non-bank financial institution—a generic NBF1 — and then leave it to individual NBFI’s to determine what they call themselves and to the market to determine whether this is credible.

This is how the banks are supervised: the Banking Act regulates banks but allows a variety of types of banks, including one small mutual bank, to operate under a common set of prudential standards.

Credit unions are placed in a particularly restrictive position in having to meet a capital adequacy requirement of 75 per cent in Tier 1, unlike both building societies and banks, which have to maintain a minimum of only 50 per cent in Tier 1 capital.

It may be argued that the different capital requirements are necessary to take account of the difference in risks borne by depositors in credit unions. However, in both formal and actual terms, the role
of a depositor in a mutual society is quite different from that of a depositor in a proprietary company. In a mutual society, a depositor is a member of the society, has voting rights, and is entitled to share in the profits of the society; hence, the role of depositor and equity participant is blurred. A depositor in a proprietary company, such as one of the Big Four banks or a building society listed on the stock exchange, has no right to participate in the profit of the company.

A depositor in a mutual society bears, and should bear, a greater degree of risk than a depositor in a proprietary company. Hence, mutual societies should have a lesser, rather than greater, prudential standard than a proprietary company.

We suggested earlier that the introduction of the new prudential standards had distorted the lending policies of credit unions. This is partly because of the inability of credit unions to raise share capital.

If it is thought necessary to require credit unions to be mutual societies — and we say that this should be a choice of the members — it is possible to devise new forms of capital which can preserve the organisational status of credit unions but allow them to raise permanent capital. One such type of capital is that proposed for UK building societies. This form of capital, referred to as permanent interest-bearing shares (PIBS), has the following characteristics:

- it will be permanent;
- it will be interest-bearing, not profit-related;
- interest can be waived, if the society's capital position requires it;
- it can be written down to absorb losses without triggering a winding-up of the society; and
- on winding up a society, holders of PIBS rank behind not only ordinary creditors, including depositors, but also holders of withdrawable share capital and subordinated debt.

Additionally, even though PIBS would not carry voting rights, they could be tradeable in a secondary market which would provide a market test, now lacking, for the management of credit unions and other societies.

The future of building societies

The new legislation has affected building societies in a profound way; the first-order effects appear to be much more severe than for credit unions. What will the industry be like in the next couple of years? A survey was made of all building societies in a attempt to determine what the institutions themselves thought.

More than 50 per cent of the industry responded to a questionnaire on strategies to meet the demands of the industry in the next few years. Responses made it clear that maintaining profitability was of prime importance. How societies were to achieve this varied considerably. The main themes were:

- to expand products, and therefore markets; or
- to increase profitability through the containment of expenses rather than growth.

The importance of containing expenses is clearly related to profit margins, and therefore to the ability of institutions to expand and to raise capital. Not surprisingly, emphasis on capital raising came from societies at the lower end of the asset-size scale. The larger societies saw the need to concentrate on developing a stronger business relationships.

Managements have been forced to review the way they conduct business. Old practices are being revamped and new ones considered. Survey respondents unanimously confirmed that the attitudes of management are changing, regardless of size of assets, number of branches, staff and geographical position.

An important element in the change of attitudes is the way in which the societies meet capital requirements for their operations now and in the future. Capital-raising methods can be placed into three categories. Of the societies which replied to the survey question, 46 per cent meet their current capital needs through retained profits. Tier 2 capital meets the needs of a further 31 per cent.

This method of capital raising is becoming increasingly necessary for institutions, due to the need for compliance to the AFIC legislation.

The remaining 23 per cent have taken a mixed approach, not relying on one method to obtain capital. The mixed approach to capital raising is likely to become more prevalent as building societies attempt to diversify to ensure that capital will always be available. Most building societies in the survey which indicated these last two forms of current capital raising have an asset size of between $101 million and $500 million. The larger and smaller societies have relied on retained profits, indicating that they have so far had to be self-sustaining.

What then of future capital needs? The survey indicated that 50 per cent of building societies did not expect to issue shares, use subordinated debt or float on the stock exchange. These societies currently met capital needs through retained profits. This appears to be in line with earlier indications of future directions in the industry. With a strong regional focus expected, building societies felt confident that they could satisfactorily meet any demands placed on them. That is, growth of market share would not be of sufficient size to cause capital shortages. The remaining societies were keeping their options open and had considered one or more alternatives for future capital raising.

As noted, the need for capital is dependent on a society's plans to expand operations. Almost 57 per cent of respondents stated that they have considered taking over other institutions. This is in keeping with the comments made by societies in relation to the future direction of the industry, which is expected.
to undergo further consolidation. The societies which responded positively to this question were mainly the smaller and middle-sized institutions, those with assets of less than $100 million and those with assets between $100 million and $500 million.

This is somewhat surprising because of two factors. First, one would expect the larger institutions to be the ones looking for opportunities for takeover. Second, of those societies indicating their interest in takeovers, nearly half are currently using, and will continue to look towards, retained profits to meet their capital needs.

What is even more interesting is that only 14 per cent of the societies see themselves as targets for takeover — and these societies have an asset size of between $501 million and $1 billion. One would have assumed it more likely that the smaller societies would be swallowed by the larger institutions. On the other hand, however, the takeover of larger societies means the acquisition of a larger market share.

The increase in asset bases associated with the growth of building societies, whether from acquisitions or other means, leads to the assumption that more societies would convert to bank status. This would be in keeping with the Martin Report recommendation that societies with assets over $1 billion should convert to banks.

However, bank status is apparently not a direction in which the societies wish to go. Seventy-one per cent of survey participants indicated that they intended to stay as mutual organisations. They believed that changing to bank status would be entirely against the existing cultures of the organisations, indicating that the societies view their position as unique.

It is therefore not unreasonable to conclude that the introduction of the AFIC legislation has not adversely affected the building societies to any great extent. They feel confident that they are able to profitably operate in the financial services industry.

The exit of some societies from the sector has had a marked effect on the rest of the industry. The conversion to banks by St George and the Co-operative placed extra pressure placed on the remaining societies. The diminished industry is left with a larger burden in terms of funding AFIC. This becomes of particular interest when considering the speculation surrounding the future of Suncorp Building Society. With a decreasing number of institutions and increasing costs, there may be little option for the building societies but to be classified as generic NBFIs.

Several factors can be considered imperative to the culture of any institution, regardless of its industry. Two such issues for building societies are the prospect of foreign ownership and the grouping of all NBFIs in one category.

The survey results indicated that no institution was considering the possibility of foreign ownership. The introduction of a foreign institution was viewed as detrimental, not so much in the performance of the local institution in the marketplace as in terms of the culture of the organisation. Australian building societies view their role as a specialised one in the provision of financial services, and their culture as fundamentally different from those of other institutions. The question of foreign ownership as a method of gaining access to more capital was raised in the survey. But, as discussed earlier, the societies felt confident that they were able to meet the future requirements of the market.

The Brady Committee introduced the concept of having all NBFIs classified under one title. It was not envisaged that institutions would lose their independence or identity. The Brady Committee proposed, in fact, that the legislation governing deposit-taking institutions be amended to allow the movement of institutions between groups. This proposal, however, met with varying responses when posed in the questionnaire. Most respondents indicated that they would be unwilling to be classified as generic NBFIs.

The freedom given to building societies under the AFIC legislation has allowed these institutions to expand their product base to include commercial loans. Asked whether they had considered taking up this option, the institutions were evenly divided. Of those which were engaged in commercial lending, or were proposing to do so, very few intended to move interstate to tap new markets. There is confidence that the market in which they operate is able to support another loan product.

The apparent lack of desire of institutions to expand interstate implies a number of things. Generally, societies feel that it will gain them little. They may believe the market is already saturated and the competition too fierce for them to make much headway. Further, the cost of moving interstate may not be offset by the potential returns. This is an important consideration at a time when cost-conscious institutions are striving to maintain profit margins.

Introduction of the AFIC legislation has been the culmination of several studies into the non-bank industry. Pressure for change had come from all sectors of the community, government, the societies themselves and the consumer. The main concern was that the industry should be regulated so as to provide the consumer with security and choice. This required a high degree of competition with strong guidelines to ensure that funds are protected.

The new legislation was intended to meet these criteria, with emphasis on increased competition. Institutions are now able to provide commercial loans and operate interstate, allowing for the expansion of balance sheets and a higher degree of choice for the consumer.

This, however, has been far from successful. What has resulted is the rationalisation of the number of competitors operating in the market and the range of products being offered. Many building societies have indicated that they are unwilling to capitalise on the new freedom offered to them.

Have the committees of inquiry got it wrong? The industry appears to be taking on a completely different face than that expected by the inquiries. The AFIC legislation has failed to meet its objectives of increased competition and security.

A key influence will be how the banks react to the changes within the industry. The new requirements have left several institutions struggling to maintain their current operations and work towards future goals. This has left many exposed to the possibility of takeover. Although the building societies feel little threat from takeover, the possibility exists. While the societies experience difficulty in maintaining profitability, the banks are finding new strengths. Should the building societies experience an increase in profitability, the banks will undoubtedly consider takeovers.

This raises questions about the positioning of building societies and credit unions as separate entities in the non-banking sector. Despite the unwillingness of many societies to be categorised as generic NBFIs, there appear to be few alternatives.